

# Public Company Advisor

## Practical Insights for Public Company Counsel

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*King & Spalding's Public Company Practice Group periodically publishes the Public Company Advisor to provide practical insights into current corporate governance, securities compliance and other topics of interest to public company counsel.*

### **Fine-Tuning Your Insider Trading Policy**

Several recent high-profile insider trading cases have highlighted the Securities and Exchange Commission's continued focus on insider trading enforcement. In fact, according to the SEC, over the last three years it has filed more insider trading enforcement actions than in any other three-year period in its history.

This continued SEC focus serves as a reminder that public companies should periodically re-evaluate their insider trading compliance policies and programs to ensure they are appropriate. Companies' compliance programs are important not just for the employees and directors that they regulate, but also for the company as an organization. Under the federal securities laws, if a public company does not maintain adequate insider trading compliance programs and procedures, the company itself can be subject to "controlling person" liability for violations of the insider trading laws by persons that the company is deemed to control (such as employees, officers and directors).

In this *Public Company Advisor*, we highlight several of the items that we have recently addressed in advising clients with respect to their insider trading compliance policies. These items are among those that companies may wish to consider in reviewing and updating their insider trading compliance policies.

#### **Social Media**

Many companies' insider trading policies were adopted prior to the explosion in communication through social media. Directors and executives of public companies are increasingly communicating via Twitter, Facebook and other social media platforms, and the company may be at risk when an insider discloses confidential information about the company's business. Companies should consider updating their insider trading policies to clarify that the prohibitions on unauthorized dissemination of material non-public information or any of the company's confidential information apply equally to communications made through social media.

#### **Expert Networks**

Expert networks are firms that connect investment firms and others seeking information about specific industries, companies, products or business situations with outside experts who are able to provide information on such topics. The "experts" are typically independent contractors who are paid on an hourly basis for providing information to clients of the network. In several recent high-profile enforcement actions, the SEC has charged members of expert network firms

with violations of insider trading laws for providing material non-public information concerning public companies. In some of these cases, the SEC has alleged that employees of public companies were moonlighting as consultants and disclosing material nonpublic information concerning their companies or business partners of their companies.

A company's insider trading policy will always prohibit disclosure of material nonpublic information concerning the company; however, not all clearly cover dissemination of material nonpublic information concerning other companies that covered persons gain as a result of their employment. In light of the recent expert network cases, companies should consider updating their insider trading policies to clarify that employees are prohibited from disclosing any material nonpublic information that they gain as part of their employment. In addition, companies should consider whether they may want to adopt a policy that their employees and directors may not act as consultants or employees of expert network firms or any other enterprises.

### **Trading Windows**

Insider trading policies typically restrict trading by directors and senior officers to trading "windows", because these individuals have routine access to material nonpublic financial information. These trading windows typically open following release of quarterly earnings data and close a specified period prior to the end of each fiscal quarter.

The amount of time prior to quarter end that a window closes should be evaluated based on any changes in the nature of a company's business and its financial reporting processes.

Accordingly, as a company's business evolves, it should evaluate from time to time whether the closing of its trading window still matches the reality of its business. For example, the closing date for the trading window may need to be advanced if material nonpublic financial information is becoming available to directors and officers earlier than in the past.

### **Prohibition on Hedging and Pledging**

When the stock market declined dramatically in the Fall of 2008, many companies faced difficult decisions as their executive officers or directors encountered margin calls on pledged securities and other sudden needs for liquidity. These events often occurred at times when the insiders were not in a position to sell their company securities, due to adverse business developments that had not yet been publicly disclosed by the companies. There was also a backlash by investors when they suffered losses, but discovered that top company executives had hedged their stock positions.

As a result, investors and regulators began to focus on hedging and pledging of company securities by insiders. While the SEC has not yet adopted regulations mandated by Dodd-Frank that will require disclosure of hedging by company insiders, Institutional Shareholder Services has adopted updated policies on hedging and pledging. Under its proxy voting policies, ISS will recommend against some or all director candidates at a company that has hedging or significant pledging by directors or executive officers.

Certain types of hedging transactions are speculative in nature and could undermine the incentive for an insider who hedges her ownership position to take actions in accordance with the long-term interests of other stockholders. Hedging transactions by officers and directors may also create the appearance of misuse of inside information. Accordingly, many companies' insider trading policies already prohibit derivative-based hedging in company securities, and other companies should review the existing provisions in their insider trading policies regarding hedging transactions. Companies should consider prohibiting directors and executive officers from derivative-based transactions that have the effect of hedging their ownership positions in company securities, and may also wish to extend these prohibitions to cover other employees.

Similarly, pledging of securities by insiders, including margin arrangements, could also undermine the alignment of insiders' incentives with the long-term interests of other

stockholders. In addition, a forced sale of an insider's pledged shares at a time when the insider has material non-public information could violate insider trading laws. In light of this concern, many insider trading policies already have provisions strongly discouraging pledging. However, such provisions may no longer be adequate in light of ISS's position that any significant pledging by directors or executive officers merits a withhold vote against directors. Accordingly, companies should review their insider trading policies to confirm that pledging of company securities is prohibited, at least for directors and executive officers.

In implementing any prohibition on pledging, companies should also carefully consider any existing arrangements that could result in deemed pledging of company securities. For example, an insider who wishes to maintain a margin brokerage account should ensure that his company securities are segregated in a separate account not subject to use as collateral for any margin loans.

### **Coverage of Other Persons**

One of the most challenging aspects of insider trading compliance policies is their coverage of persons other than the employee, officer or director himself. For example, certain provisions of the policies should apply to family members, other persons living with the insider, persons supported by the insider and entities in which the insider may have a financial or controlling interest. The range of family situations and business arrangements that should be addressed by insider trading compliance policies has grown more complex in recent years, so it may be timely for companies to review their coverage of these matters.

### **Administration and Enforcement**

In addition to reviewing the terms of their insider trading policies, companies should confirm that responsible individuals are actually implementing the policies' requirements, including notifying employees and directors of the opening and closing of trading windows and enforcing pre-clearance procedures. If called upon to produce records showing how the company administered its insider trading compliance program, the company should consider what these records would show, in terms of training, detection of violations, and sanctions. Having an appropriate policy is only the start of an effective compliance program; sound operation of the entire program will be important if enforcement officials are reviewing the effectiveness of a company's program. Companies should ensure that newly-hired employees are educated on the terms of the insider trading policy, and that existing employees receive periodic refresher courses. Finally, when a violation is detected, companies should ensure that an appropriate penalty is imposed pursuant to the policy.

### **Conclusion**

Insider trading compliance remains of vital importance for public companies. The items described above are just a few of the key areas companies may wish to consider re-evaluating their insider trading policies. Any update should involve a thorough review of the entire policy by a company's internal legal department and/or outside securities counsel.

### **About King & Spalding's Public Company Practice Group**

King & Spalding's Public Company Practice Group is a leader in advising public companies and their boards of directors in all aspects of corporate governance, securities offerings, mergers and acquisitions and regulatory compliance and disclosure.

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